

**STATE OF ILLINOIS**  
**ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company	)	
	)	
	)	
	)	Docket No. 02-0690
	)	
Proposed general increase in	)	
water and sewer rates	)	

**CUB EXHIBIT 2.0**  
**REBUTTAL TESTIMONY OF**  
**LAFAYETTE K. MORGAN, JR.**

ON BEHALF OF THE  
CITIZENS UTILITY BOARD

APRIL 11, 2003

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## Introduction and Summary

A. The purpose of my rebuttal testimony is to respond to the rebuttal testimonies of Illinois-American Water Company (IAWC or the Company) witnesses Mark L. Johnson, R. Douglas Mitchem, Ronald D. Stafford and Frederick L. Ruckman relating to the adjustments I proposed in my direct testimony in this proceeding.

1     Reverse Osmosis Deferred Costs

2     Q.           MR. JOHNSON DISAGREES WITH YOUR ADJUSTMENT TO REVERSE THE  
3                 COMPANY'S INCLUSION OF THE REVERSE OSMOSIS COSTS IN THIS  
4                 PROCEEDING. WOULD YOU PLEASE COMMENT?

5     A.           As indicated by Mr. Johnson, the Company has had problems with high nitrate levels  
6                 at the Streator Street Water Treatment Facility. In 1991, IAWC initiated a program to  
7                 control nitrate levels at this facility, and began the design of a side-channel storage  
8                 capacity in an effort to control nitrate levels. However, the nitrate levels in the Vermilion  
9                 River (which serves as the facility's water source) dramatically changed, thus IAWC  
10                (Northern Illinois Water Company or NIWC at the time) put construction of the side-  
11                channel on hold while it investigated methods of controlling nitrate levels.

12               In ICC Docket No. 95-0220, Mr. Johnson testified that after the Company stopped  
13               the side-channel storage development IAWC conducted a preliminary review of  
14               alternatives means of controlling nitrate levels. Among the alternatives were: watershed  
15               management; constructing ion exchange treatment facilities; constructing reverse osmosis  
16               treatment facilities; constructing electro dialysis treatment facilities; and blending the river  
17               water with ground water.

18               In that proceeding, the Company sought to defer the costs of these alternatives and  
19               recover them over a five-year period. ICC Staff witness Garret Gorniak testified in  
20               support of such a recovery.

21    Q.           WERE THE REVERSE OSMOSIS TREATMENT FACILITIES A COMPONENT  
22                 OF THE PROGRAM FOR WHICH THE FIVE-YEAR AMORTIZATION WAS  
23                 ALLOWED?

24    A.           No. The reverse osmosis treatment facilities were not a component of the program.  
25                 The ion exchange treatment facility was the only pilot facility included in the program.

1 Q HOW DID THE COMPANY SOLVE THE HIGH NITRATE PROBLEM?

2 A. The Company was able to reduce nitrate levels through a watershed management  
3 program, which was one of the alternatives identified in their preliminary review.

4 According to the Company, the watershed management program worked until 2001.<sup>1</sup>

5 Q. DO YOU AGREE WITH MR. JOHNSON'S CHARACTERIZATION OF THESE  
6 COSTS AS "INVESTIGATIVE?"

7 A. No. The Company had already conducted an investigation of the alternatives available  
8 to reduce nitrates at the facility.<sup>2</sup> That phase of the process had been completed. All that  
9 remained was implementing the appropriate alternative. As stated above, IAWC  
10 successfully utilized the watershed management alternative. After nitrate levels began to  
11 increase in 2001, the Company used another one of its alternatives, the side-channel  
12 reservoir, for blending water until the reservoir was depleted. Given that the Company  
13 needed to maintain water quality it pursued another alternative, which was the reverse  
14 osmosis process to lower nitrate levels. Even if the reverse osmosis process resulted in  
15 data being gathered as to its effectiveness and costs, one would expect that to be the case  
16 since it was the first time that the Company had used the technology.

17 The reverse osmosis costs were neither study nor investigative costs similar to the  
18 amortization costs identified in ICC Docket No. 95-0220, since these really pertained to  
19 the implementation of the alternative previously studied and explored by the company.

20 Accordingly, the Commission should disallow recovery of these costs.

21 Payroll Expense

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<sup>1</sup> Rebuttal Testimony of Mark Johnson, page 6, line 18.

<sup>2</sup> IAWC Response to staff Data Request MHE-2.09 (Relevant portion is attached and incorporated as CUB Ex. 2.1).

1 Q. MR. STAFFORD STATES THAT THE COMPANY HAS EXPLAINED WHY THE  
2 TRANSFER OF EMPLOYEES TO THE SERVICE COMPANY IS NOT EXPECTED  
3 TO RESULT IN ANY ADDITIONAL SAVINGS OR COSTS. DO YOU AGREE?

4 A. No. In response to CUB 1.16 (attached and incorporated herein in its entirety as CUB  
5 Ex. 2.2), the Company indicated that six employees were being transferred from IAWC to  
6 the Service Company. Prior to their transfer, these employees were 100 percent dedicated  
7 to IAWC. While the Company believes it has adequately explained why there will be no  
8 cost changes, there are certain facts that the Company has not adequately explained. First,  
9 as Service Company employees, these individuals may perform projects for other  
10 American Water Works Company subsidiaries. Yet the Company proposes to include 100  
11 percent of their salary in its cost of service. Second, if the transfer of these employees was  
12 planned, it is possible that their salaries will be included in the budgeted costs from the  
13 Service Company that are included in the cost of service. IAWC has not demonstrated  
14 that these costs have been properly adjusted.

15 Insufficient Data

16 Q. YOU HAVE BEEN CRITICIZED FOR NOT REQUESTING DATA FOR  
17 CERTAIN COSTS THAT YOU ADJUSTED OUT OF THE COST OF SERVICE.  
18 WHY DID YOU NOT REQUEST THE ADDITIONAL DATA?

19 A. During the initial discovery stage of the proceeding, I took two approaches to  
20 obtaining necessary data from the Company. First, I reviewed Data Requests submitted  
21 by other parties in this proceeding and to the extent that those parties were requesting  
22 information that appeared to be similar to the information I needed, I did not submit  
23 duplicative Data Requests. The other approach was to request specific information I  
24 needed which I did not find elsewhere. At first glance, I assumed that the Company  
25 responded fully and adequately to the Data Requests I propounded. Upon further review,

1 I determined that the Company's responses were insufficient to fully address the questions  
2 posed. Accordingly, subsequent to filing my Direct Testimony, I issued additional Data  
3 Requests to the Company in an effort to determine whether certain costs should be  
4 allowed.

5 Q. CAN YOU ADDRESS THE VARIOUS ADJUSTMENTS THAT YOU REMOVED  
6 BECAUSE OF INADEQUATE DATA?

7 A. Yes. Initially I removed the Company's proposed costs associated with: 1) the  
8 National Call Center; 2) Group Insurance; 3) Customer Expense; and 4) On-going  
9 Security Costs.

10 *1) National Call Center*

11 Mr. Stafford identifies CUB Data Request 2.13 (attached and incorporated herein in  
12 its entirety as CUB Ex. 2.3), and claims that the response provides detailed data, thereby  
13 implying that the Company fully responded to CUB's request. However, the request  
14 clearly and specifically asked for evidence that one-time costs had been removed. The  
15 response provided by the Company did not attempt to address that concern. The IAWC  
16 referred CUB to the Company's response to Illinois Industrial Water Customers' (IIWC)  
17 Data Request No. 2.1 (attached and incorporated herein in its entirety as CUB Ex. 2.4).  
18 However, that response shows the total projected 2003 costs **without** any supporting  
19 data. Clearly that response to the Data Request was completely inadequate in light of the  
20 specific request. At the time of my initial review, I took the Company at its word that the  
21 response would be fully addressed in the response to which I was referred, rather than "sit  
22 back in silence and then complain" as Mr Stafford stated. At the time that I began to  
23 prepare my testimony, I sought the information only to find that it was not fully  
24 responsive. Therefore, I indicated in my direct testimony why the adjustment was made  
25 and offered to revise it when the Company provided the data.

1                   2) *Group Insurance*

2                   CUB Data Request No. 2.14 (attached and incorporated herein in its entirety as CUB  
3                   Ex. 2.5), specifically requested support for IAWC's 13.5 percent escalation rate. As Mr.  
4                   Stafford pointed out in his rebuttal testimony, I was referred to the response to CUB Data  
5                   Request No. 2.05 (relevant portion is attached and incorporated herein as CUB Ex. 2.6).  
6                   While he implies that the response to CUB No. 2.05 was responsive, the workpaper to  
7                   which I was referred only showed the 13.5 percent factor—the company failed to provide  
8                   support for its calculations.

9                   3) *Customer Expense*

10                  CUB Data Request No. 2.17 (relevant portion is attached and incorporated herein as  
11                  CUB Ex. 2.7) requested the derivation of the projected customer expenses. The Company  
12                  provided a workpaper showing the application of a 2.5 percent inflation factor. However,  
13                  for office supplies, not only was there a 33 percent increase, which was not explained, but  
14                  also, postage increased by 8.8 percent without explanation. I removed the adjustment  
15                  pending additional information rather than accepting an unexplained projection.

16                  4) *On-going Security*

17                  CUB Data Request No. 2.20 (attached and incorporated herein in its entirety as CUB  
18                  Ex. 2.8) requested separate support for ongoing security costs however, the Company's  
19                  response was completely void of any support for this expense. At the time of filing my  
20                  testimony, I had to make a judgment whether or not to accept an unsupported amount. I  
21                  chose to preserve the issue by removing those costs and agreeing to adjust them once the  
22                  Company provided proper support, rather than accept the Company's proposed but  
23                  unsupported amounts.

24                  It is important to note that the reason for removing those costs was to ensure that they  
25                  were adequately addressed. It was not CUB's intention to imply that the Company did

1 not act in good faith. Nevertheless, I have submitted follow-up Data Requests for data to  
2 address those concerns.

3 Q. HOW HAVE YOU RESOLVED THOSE ISSUES?

4 A. As a result of additional data provided by IAWC, coupled with other intervenors'  
5 testimonies, I am satisfied that those costs included by the IAWC are reasonable.  
6 Therefore, I am withdrawing my adjustments to remove them.

7 Insurance Other Than Group

8 Q. MR. STAFFORD STATED THAT YOU HAVE NOT PROPERLY  
9 CHARACTERIZED THE INSURANCE COSTS ADJUSTMENTS THAT YOU  
10 IDENTIFIED AS RETROACTIVE PREMIUMS. WHY DID YOU CHOOSE TO  
11 DESCRIBE THE ADJUSTMENTS AS RETROACTIVE ADJUSTMENTS?

12 A. I have described these adjustments as retroactive because the Company, in Exhibit No.  
13 4.1, page 12 of its filing, identified them as "retrospective." The word retrospective  
14 means looking back at past events. Given that the Company included additional  
15 retrospective premiums, the result is to include past costs in current rates. As one can see,  
16 there was no attempt on my part to mischaracterize the nature of these costs.

17 Q. MR. STAFFORD DESCRIBES THE COMPANY'S INSURANCE FUNDING AS  
18 BEING MORE COST EFFECTIVE AND AS HAVING CASH FLOW BENEFITS.  
19 WOULD YOU PLEASE COMMENT?

20 A. Yes. In my adjustment, I am not attempting to dispute the cost effectiveness of the  
21 Company's insurance program. However, what is clear from the Company's data is that  
22 not only is the Company attempting to include costs related to ongoing insurance, but  
23 also, it is attempting to collect costs for specific past events. Rates are designed to  
24 recover prospective costs. Therefore it would be unfair to include in future rates past  
25 costs.



1    Chemicals Expense

2    Q.       MR. STAFFORD INDICATES THAT THE COMPANY HAS ACCEPTED THE  
3           ADJUSTMENT PROPOSED BY STAFF WITNESS SMITH, WHICH HE CLAIMS IS  
4           THE ACTUAL 2003 CHEMICALS EXPENSE. HE CONCLUDES THAT THE  
5           ADJUSTMENT YOU PROPOSE IS MOOT. DO YOU AGREE?

6    A.       No. Mr. Stafford states that the Company has provided the actual 2003 chemicals  
7           expense, which was also confirmed by the adjustment proposed by Staff. However, given  
8           that 2003 is not complete, it is not possible for the actual chemicals expense to be  
9           determined. Hence, I do not believe my adjustment has been made moot. In response to  
10          Staff Data Request TQS 2.9 (attached and incorporated herein in its entirety as CUB Ex.  
11          2.9), the Company provided the actual chemical prices that resulted from the bidding  
12          process. I applied those prices to the budgeted chemical consumption used by the  
13          Company to develop the budgeted chemicals expense. I then compared the resulting  
14          chemicals expense to the amount projected by the Company in the cost of service, to  
15          derive the adjustment. Given that my adjustment merely replaced estimated prices with  
16          actual prices, the resulting adjustment appears to be appropriate. However, if the  
17          Company has changed the assumptions it used to develop the chemical consumption, then  
18          it should have disclosed the change when responding to the Data Request.

19   Waste Disposal Expense

20   Q.       HAVE YOU CHANGED YOUR POSITION ON THE WASTE DISPOSAL COST  
21          ADJUSTMENT?

22   A.       Yes. After filing my testimony I became aware that the waste disposal costs are  
23          separately tracked and recovered by separate tariff. Therefore, my concerns about an  
24          over-recovery are lessened because of the Commission's oversight when those tariffs are  
25          changed.

1 Q. IN YOUR DIRECT TESTIMONY, YOU RECCOMENDED AN OVERALL  
2 INCREASE OF \$15,675,831. HAS THAT NUMBER CHANGED?

3 A. Yes, based on my review of the responses to the various data requests propounded as  
4 well as my review of the testimony filed to date, and the adjustments discussed above, I  
5 recommend an overall increase of \$27,576,134. This is reflected on Schedule LKM-18  
6 (attached). This reflects an \$8,680,120 reduction in the Company's requested increase.

7 I note also that I concur with the 10.27% return on equity adopted by IAWC in the  
8 rebuttal testimony of IAWC witness Ruckman. I understand that Staff also concurs with  
9 this figure.

10 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

11 A. Yes, it does.